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FEDERAL COMMUNICATIONS COMMISSION  
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April 17, 1995

Mr. William F. Caton  
Acting Secretary  
Federal Communications Commission  
1919 M Street, N.W.  
Washington, D.C. 20554

DOCKET FILE COPY ORIGINAL

RE: Price Cap Performance Review for Local  
Exchange Carriers; Treatment of Video Dialtone  
Services Under Price Cap Regulation CC Docket No. 94-1

Dear Mr. Caton:

Pursuant to Sections 1.415 and 1.419 of the Commission's Rules, attached please find an original and 4 copies of the Comments of the Ad Hoc Telecommunications Users Committee, in the above captioned matter. Please date stamp the additional copy and return it with our messenger.

If you have any questions regarding this filing, please do not hesitate to call.

Sincerely,

  
James S. Blaszak

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for Local Exchange Carriers; )  
Treatment of Video Dialtone Services )  
Under Price Cap Regulation )

CC Docket No. 94-1

INITIAL COMMENTS OF THE  
AD HOC TELECOMMUNICATIONS USER COMMITTEE

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INITIAL COMMENTS OF THE  
AD HOC TELECOMMUNICATIONS USER COMMITTEE

I. SUMMARY

The Ad Hoc Telecommunications Users Committee ("Ad Hoc Committee" or "Committee") hereby submits its Initial Comments in response to the Commission's *Further Notice of Proposed Rule Making* ("FNPRM") in the above-captioned proceeding.

In the FNPRM, the Commission has tentatively concluded that a separate price cap basket for video dialtone ("VDT") service should be established. The

Ad Hoc Committee generally agrees with and endorses the findings and tentative conclusions set forth in the FNPRM.<sup>1</sup>

The Ad Hoc Committee previously has expressed its concern that capital investments and other costs motivated by LEC goals of entering the video services business would be shifted inappropriately but quite decidedly to customers of other LEC services, particularly voice and narrowband services for which LECs face no consequential level of competition. As an economic matter, LECs possess the market power and thus are able to impose rates for monopoly voice and narrowband services so as to generate substantial amounts of cash with which to carry on their highly competitive and highly risky video pursuits.<sup>2</sup>

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<sup>1</sup> *Price Cap Performance Review for Local Exchange Carriers; Treatment of Video Dialtone Services Under Price Cap Regulation*, Further Notice of Proposed Rulemaking, CC Docket No. 94-1, FCC 95-49 (released February 15, 1995.) ("FNPRM").

<sup>2</sup> While the Commission has determined that all video dialtone services provided at least partially by means of radio waves are interstate services over which it has exclusive jurisdiction *Telephone Company-Cable Television Cross-Ownership Rules, Sections 63.54 - 63.58*, Mem. Op. & Order on Recon. and Third Further Notice of Proposed Rulemaking, FCC CC Docket No. 87-266, FCC 94-269, 10 FCC Rcd 244, 301 (1994), the majority of the costs associated with the construction and operation of those broadband transport and distribution facilities which are classified by a LEC as "common" will, in accordance with Part 36 of the Commission's Rules, be assigned to the state jurisdictions for recovery through revenues from state-regulated services. In principle, states could in some instances adopt different definitions of "common costs" than those proposed by the LECs and hence could exclude such investments for ratemaking purposes from state-regulated LEC services. In practice, once these new assets have been integrated into the LEC infrastructure, such exclusions would be highly unlikely.

Price cap regulation can, in principle, prevent the undue exercise of such market power but only to the extent that the price adjustment mechanism itself accurately reflects the rate of change in LEC costs that would be required for it to furnish, on an ongoing basis, those services for which such market power is present. An inadequate X factor does not prevent cross-subsidization; indeed, it facilitates it. The recent decision by the Commission to raise the X factor<sup>3</sup> and to recognize the inadequacy of the X factor that had been adopted for LECs in CC Docket 87-313<sup>4</sup> was a step in the right direction, but still falls far short of an economically correct inflation-offset level. Accordingly, the recent ruling in CC Docket 94-1 does not obviate the need for the separate treatment of video dialtone and other broadband services that are proposed in this FNPRM, and indeed the confluence of the price cap regime and the video based motivations driving LEC investment decisions make the Commission's proposals here all the more imperative.

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<sup>3</sup> *Price Cap Performance Review for Local Exchange Carriers*, First Report & Order, CC Docket No. 94-1 at 10 (Released April 7, 1995) ("Price Cap Order").

<sup>4</sup> *Id.* at 93.

The Committee agrees with the Commission's tentative finding that a separate price cap basket is needed for video dialtone and other new broadband transport services. However, while creation of a separate video dialtone basket is necessary as a defense against cross-subsidization and anticompetitive tactics on the part of the price cap LECs, by itself it is not sufficient to foreclose such behavior. The Committee thus urges the Commission to unbundle the productivity factor as between video dialtone/broadband and all other price cap services, to help assure that the alleged cost improvements that have been attributed by the LECs to their deployment of broadband facilities, and used by the LECs to justify allocations of (in most cases) the overwhelming majority of those costs to voice services, would be immediately flowed through to customers of voice services rather than being diverted to support video entry. However, the Committee cannot emphasize strongly enough the limitations of price cap regulation (even with the changes discussed in the FNPRM) in addressing concerns of cross-subsidization of existing voice services. The only truly effective means for achieving the Commission's objective -- ensuring that video dialtone costs are not recovered through charges for other interstate access services -- is a diligent and thorough tariff review process and the economically correct assignment of the underlying broadband network costs to the video service category.

**II. A SEPARATE BASKET FOR VIDEO DIALTONE IS REQUIRED AS A NECESSARY, WHILE NOT SUFFICIENT, CONDITION FOR ASSURING THAT VOICE/NARROWBAND SERVICES CUSTOMERS DO NOT SUBSIDIZE CREATION OF LEC VIDEO SERVICES.**

The basic rationale offered by the Commission for the proposed creation of a separate VDT "basket" is the prevention of cross-subsidization of these services by services in other baskets, or among service categories grouped within the same basket. As the Commission correctly notes at paragraph 5 of the FNPRM that, "[t]he service categories prevent a LEC from offsetting increases in the prices of services within one category by reducing the prices of services in another category of the same basket." The FNPRM goes on to elaborate:

The price cap baskets and service categories established by the Commission are designed to balance the competing interests of LECs and their ratepayers. The Commission intended to give LECs sufficient pricing flexibility as an incentive to be efficient and productive, without subjecting ratepayers to precipitous fluctuations in prices for LEC services or allowing LECs to discriminate against one class of ratepayers at the expense of another class. Moreover, the assignment of services to price cap baskets and service categories is intended to replicate the effect that a competitive market would have on pricing practices. Grouping services with common characteristics, such as similar levels of competition, within the same basket is intended to give the LECs pricing flexibility with respect to comparable services and to restrict the ability of LECs to offset increases for some services with rate decreases for dissimilar services. Price cap LECs receive streamlined tariffing procedures for rate changes that are within the appropriate PCI for the basket and, where applicable, within the service category bands. *Id.* at ¶ 7.



On an ongoing basis, it is likely that LECs will be confronted with the need to maintain very aggressive pricing for video services in order to compete with incumbent cable operators, so the separation of video into its own basket would clearly be in the public interest and should therefore be strongly supported. It may be argued that, inasmuch as "basic" video dialtone service (the only part of the LEC video entry that will be subject to price cap regulation) will constitute a relatively small share of total LEC interstate revenues in the near term, the exclusion of VDT from the "traffic sensitive" basket, for example, would likely have only a *de minimis* effect upon conventional access services prices. However, the inclusion of VDT would permit LECs to continually reduce the price of video services<sup>5</sup> without suffering any net revenue decrease, because they could easily offset the revenue losses by raising rates for services in the "traffic sensitive" basket while still remaining under the overall cap.<sup>6</sup>

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<sup>5</sup> In their Section 214 video dialtone applications, most LECs have sought to attribute the overwhelming majority of the costs of new broadband transport and distribution facilities to a so-called "common" category, on the notion that, once in place, these facilities would be used jointly to furnish video/broadband as well as conventional voice/narrowband services. For example, of the total investment identified by Bell Atlantic in connection with the building of its proposed broadband network in Dover, New Jersey, 95% is treated as common investment to be assigned to both video and telephony -- the final result being a 68% allocation of total investment to telephony and only 32% to video (see Bell Atlantic Transmittal 741, Tariff F.C.C. No. 10, January 27, 1995, Workpapers 5-3 and 5-4. The Ad Hoc Committee and others have argued that, inasmuch as the principal driver for the acquisition of these new facilities is the LECs' desire to offer video and other broadband services, these allegedly "common" costs should in fact be considered as constituting part of the *incremental costs* of these new services. While the ultimate treatment of these "common" costs will (presumably) be addressed in the tariff review process, to the extent that the LECs' view of "common" costs is adopted (which it should not be), the incremental costs that would then serve as a "price floor" for new video dialtone and other services would be so low as to permit the LECs to adopt virtually any imaginable price level for these services.

<sup>6</sup> To the extent that *incremental cost* is to serve as a price floor, there would be no requirement that the LECs set video dialtone or other broadband service rates to recover as much as one cent of the

**III. VIDEO DIALTONE OFFERINGS ARE DIFFERENT, BOTH ECONOMICALLY AND COMPETITIVELY, FROM OTHER PRICE CAP LEC SERVICES.**

Video dialtone offerings differ in many important respects from existing price cap services. First, they involve a fundamentally different market than conventional LEC common carrier offerings. Most LEC services support point-to-point communications rather than mass distribution of broadcast signals. LECs are new to the mass distribution (mass media) market, where they confront a formidable and entrenched service infrastructure consisting of over-the-air, satellite, cable television, prerecorded media, and specialized distribution channels like LPTV and ITFS. Second, unlike most other "new" LEC services that have been introduced in recent years, video dialtone is not a byproduct of evolutionary upgrades to the voice/narrowband network (e.g., CLASS services, ISDN) but instead requires, as a threshold matter, the construction of an entirely new distribution infrastructure that will overlay the copper twisted pair facilities that have been ubiquitously and universally deployed to all corners of the nation. Third, in addition to the formidable competition that LECs face in these markets, video dialtone is inherently a highly discretionary service, having little in common with the essential character of basic residential and business exchange

(..continued)

"common costs" whole incurrence was itself engendered by the very decision to enter the video/broadband market. Accordingly, absent the discipline of a separate video/broadband basket, LECs would be free to recover 100% of all "common costs" from conventional voice and narrowband services.

access ("dial tone") and exchange message services. Indeed, even the use of the "dialtone" term in describing LEC video services is a misnomer: Conventional "dial tone" lines afford users the ability to access and to communicate with virtually any other telephone ("dial tone") line in the world; by contrast, users of LEC "video dialtone" services will be able to access only a limited number (perhaps a few hundred at most) video content services that may be offered by LECs, their affiliates, or by third-parties. Today, only about 60% of U.S. households, and hardly any U.S. businesses, are connected to a "wired" video service such as cable television. A far smaller number subscribe for "premium" video services, underscoring the extreme sensitivity of consumers to the prices of these discretionary, largely entertainment-oriented purchases. Indeed, in addition to competing with other mass video media (broadcast and cable television, home satellite services, and videocassettes), LEC video dialtone also competes generally for the consumer's entertainment spending, which includes sports, movies, live performances, books and magazines, and other leisure-oriented expenditures. LECs have never had the experience of competing in such discretionary and competitive markets, and no other price cap service comes even close to displaying demand or supply characteristics similar to those of video dialtone service.

As the "new kid on the block" in the mass media marketplace, the LECs will necessarily seek to exercise every possible competitive advantage that they

may possess. This would include, *inter alia*, shifting as much of the cost of the new video/broadband facilities as possible to conventional, non-video services; pricing video services so as to forego any consequential amount of contribution toward the "common costs" (including the common network costs) of providing video services jointly with conventional voice and narrowband services; relying upon relatively stable revenue and earnings associated with monopoly price cap services to shelter the risks attendant to entry into this new market; and where possible increase prices for monopoly services to the maximum permissible extent to provide cash to support the capital demands of the video/broadband business.

Each and all of these tactics and strategies would be greatly facilitated if video dialtone can be co-mingled with monopoly voice/narrowband services into a single price cap basket. With mingling, LECs could, with impunity, easily increase their profit levels on non-video monopoly services while suffering even sustained losses in the video market while still nominally holding their average price level adjustments to the PCI constraint. Such co-mingling is fundamentally at odds with the Commission's goal of simulating competitive outcomes and with preventing cross-subsidization. Accordingly, there can be little doubt but that the separation of video/broadband services into their own price cap basket is necessary. However, such separation is not by itself sufficient to assure that the Commission's objectives for price cap regulation are fully satisfied; that can be

accomplished only if separate, and unbundled price cap indexes are applied to video/broadband vis-à-vis voice/narrowband baskets.

**IV. THE NEW PRICE CAP BASKET SHOULD INCLUDE OTHER SIMILAR BROADBAND TRANSPORT- AND DISTRIBUTION-RELATED SERVICES.**

As a general matter, the new price cap basket should include other transport- and distribution-related broadband services, since these can be expected to exhibit many market (demand) and production (supply) properties similar to those of video dialtone. For one, both mass media type video distribution services and more specialized broadband services delivered to the end user will necessarily utilize the very same distribution and transport infrastructure whose construction these services collectively motivated. As new and highly discretionary services, mass-distribution broadband services will confront similar market conditions to those of video dialtone. From a competitive perspective, LEC broadband services will face stiff competition from other sources, including many of the same rivals that LECs will face in the video dialtone market. Indeed, the potential involvement of broadcast, cable television, and home satellite entities in the interactive broadband services market should not be lightly dismissed: While these entities may not possess the same types of two-way broadband networks that the LECs are in the process of constructing, for the most part interactive broadband services do not require --

or even benefit from -- symmetric bandwidth in both the uplink and the downlink direction.<sup>7</sup> Even where it could be shown that such non-video broadband services differ from video dialtone to a point where a separate price cap basket is indicated, in no case should such broadband services be included in *existing* price cap baskets.

V. THE PCI FORMULA FOR THE NEW VIDEO DIALTONE PRICE CAP BASKET SHOULD REFLECT A ZERO X-FACTOR, WITH A COMMENSURATE INCREASE IN THE PRODUCTIVITY FACTOR THAT IS APPLIED FOR OTHER (NON-VIDEO) PRICE CAP BASKETS.

As noted previously, the separation of video dialtone and other new broadband distribution services into their own price cap basket, while clearly necessary, is not by itself *sufficient* to assure that the Commission's objectives for price cap regulation are fully satisfied. In paragraphs 14-16 of the FNPRM, the Commission appears to recognize this concern and accordingly proposes that *different* price cap indexes ("PCIs") based upon different productivity offset factors (X factors) be applied with respect to video dialtone vis-à-vis other price cap baskets. In particular, the Commission notes that it had not required any productivity offset in establishing price cap rules for cable television companies,

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<sup>7</sup> For the most part, users of interactive services transmit far less information upstream (*i.e.*, to the service provider) than they receive downstream (*i.e.*, from the provider). In fact, the ratio of downstream to upstream information may vary from 10-to-1 (for low-speed on-line services such as Prodigy, Compuserp or America On-Line) to more than a million-to-one (for example, the case of a video-on-demand movie, where at most a few hundred bytes of data are sent upstream to order the film, with well over a gigabyte being sent back in the form of the movie itself).

thereby allowing cable TV rates to rise annually by the full GDP-PI increase; by implication, the VDT basket could similarly be endowed with a zero X factor. The Committee agrees with the notion that the PCI for a video dialtone basket should reflect a zero productivity offset (X factor) consistent with the Commission's treatment of cable television services with which video dialtone services will most directly compete. Indeed, given the massive amounts of capital proposed to be deployed by LECs to pursue video business<sup>8</sup> coupled with the relatively slow "ramp-up" of demand for LEC *video dialtone* service that is likely to be experienced,<sup>9</sup> it is difficult to imagine that LEC video dialtone productivity in the near term would be greater than that enjoyed by the incumbent cable television systems.

The Commission goes on to suggest that this type of disaggregation might also imply a higher X factor for the non-video baskets;<sup>10</sup> *i.e.*, the average X factor adopted in the price cap review would be disaggregated, with the VDT

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<sup>8</sup> See, *Infra*, at 14.

<sup>9</sup> The Committee notes, for example, that in more than a decade of competition in the interLATA long distance market, AT&T's market share still remains in the 60% range. Moreover, the opportunity for consumer selection of alternative IXCs was affirmatively provided through a "balloting" process following the availability of "equal access" in any given central office, and no on-site wiring or other installation activity was required when the customer switched long distance carriers. By contrast, there will be no balloting as between a LEC and the existing cable TV operator when VDT facilities become available in a particular community, and any decision to switch video providers will require on-site installation activity (including, in some cases, the installation of new inside video cable), in sharp contrast to the virtually transparent process by which an IXC change can be accomplished. Accordingly, the rate of LEC penetration into the video market is likely to be even slower than that experienced by IXCs for consumer long distance business.

<sup>10</sup> FNPRM at ¶ 16.

basket X factor being set equal to zero and the non-video X factor being set at a higher level, such that the average is held constant. Such a policy is not only sound, it is essential if the price cap regime is to achieve a competitive outcome and protect customers of monopoly services from excessive rate increases whose purpose would be to finance LEC entry into the video market. There are, in fact, several strong arguments in support of the Commission's disaggregation proposal:

- Inasmuch as the LECs have argued that deployment of a fiber/coax architecture produces benefits in the form of lower costs for voice/narrowband services (in support of allocations of what LECs have characterized as the "common" costs of HFC facilities to voice services), a disaggregation of the X factor between voice and video would assure that the alleged cost improvements will be immediately flowed through to customers of voice services through a higher "X" factor rather than being diverted to support video entry.
- It would establish a virtually automatic mechanism for reallocating "common" costs to the video category as the relative size of the LEC video business increases. Retention of a uniform X factor for all baskets (voice and video) would "lock in" the initial cost allocation, in which virtually no, or very little, common cost is assigned to video.



With respect to the X factor, the Commission notes:

"If the productivity factor is too low, prices will be too high, depressing demand from consumers and leading to inefficiently low levels of traffic. If the productivity factor is set too high, investment may be discouraged because carriers may conclude that investment of capital in other ventures and services is more attractive than providing video dialtone service."<sup>11</sup>

This observation suggests that the baskets and productivity offset factors should be designed so as to encourage investment specifically in video dialtone services and not to misallocate video investments in the voice baskets, which would constitute a cross-subsidy and create inefficiently high price levels for voice/narrowband services.

In this context, it is critically important that overall X factor be unbundled as between video dialtone/broadband and all other price cap services, with the unbundled video/broadband X factor set at zero, and the X factor for all else set corresponding higher so that the overall average remains set at the levels established by the Commission in its interim decision.<sup>12</sup> In deriving the unbundled video dialtone X factor, video dialtone demand levels should be weighted based upon expected (representative) demand levels consistent with that used in tariff filings to "prove out" the LECs' economic justifications and to set initial video dialtone rates. The same logic that allows LECs to use

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<sup>11</sup> *Id.* at ¶ 14.

<sup>12</sup> The Committee continues to believe that the interim values for the X factor are inadequate and that they should be increased. Our comments here do not in any way alter our view nor eliminate the need for further upward adjustments in the *overall* average offset factors.

representative demand levels to "prove" that their proposed video dialtone services will cover direct costs should also apply to the application and the weighted disaggregation of the productivity offset.

Price cap LECs have submitted Section 214 video dialtone applications collectively contemplating some \$3.5 billion in new broadband (fiber optic and coaxial cable) investment, based upon deployment plans collectively reaching some nine million customers. However, these figures generally reflect only a small portion of the total investment being made to construct the new broadband networks. For example, information provided by Bell Atlantic in its VDT for Dover, New Jersey, indicates a total investment per homes passed in the range of \$1,700.<sup>13</sup> Extrapolating from these initial applications to a scenario of universal deployment, based on the Bell Atlantic data, the price cap LECs will have invested some \$170 billion in new broadband plant by the time that the nationwide upgrade is completed. This figure is comparable in magnitude to the \$159 billion net book value of all price cap LECs combined.<sup>14</sup> Disaggregation of the X factor as between existing LEC services and new video/broadband services will thus have a material impact upon the level of the X factor that would continue to be applied for convention monopoly and other voice/narrowband

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<sup>13</sup> Bell Atlantic Transmittal 741, Tariff F.C.C. No. 10, January 27, 1995, Workpapers 5-3 and 5-4.

<sup>14</sup> The \$159 billion figure is based on the total Net Property Plant and Equipment of the Regional Bell Operating Companies, the GTE Corporation and the Rochester Telephone Company. Statistics of Communications Common Carriers, Federal Communications Commission, 1993/1994 Edition, Table 1.1.

services. Assuming, for example, that LEC video/broadband investment comes to represent, say, 40% of total LEC net investment, disaggregation of the recently-adopted 5.3% (no sharing) composite X factor would imply an 8.8% X factor for voice/narrowband baskets and a 0% X factor for video and broadband.

In this example, and accepting for the present the validity of the 5.3% composite interim X factor that has just been adopted, anything less than an 8.8% X factor applicable for non-video services would permit cross-subsidization of video/broadband by monopoly voice/narrowband to take place. Clearly, then, the creation of a separate video dialtone basket is not sufficient unless that action is coupled with an appropriate disaggregation of the composite X factor itself.

**VI. IF A SEPARATE X FACTOR IS UTILIZED AND IMPLEMENTED PROPERLY, INITIAL RATES FOR THE NEW VIDEO BASKET CAN BE SET ACCORDING TO EXISTING PRICE CAP RULES APPLICABLE FOR NEW SERVICES.**

The Commission's tentative conclusion for setting the initial rates for a new price cap basket for VDT is to rely on the Commission's existing rules for the initial pricing of new services.<sup>15</sup> That is, the new service is incorporated in baskets and is reflected in price cap indexes at the first annual price cap filing following the calendar year in which the new service is offered. On this basis,

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<sup>15</sup> FNPRM at ¶ 18.

the price cap index ("PCI") and the actual price index ("API") for new VDT basket would be assigned an initial value of 100 prior to adjustment for inflation and productivity, corresponding to rates in effect just prior to the effective date of the annual filings in which the VDT basket is introduced.

Application of the "new service" rules, of course, presupposes that the initial rates are lawful and that they themselves do not involve any unlawful cross-subsidization or discrimination. In that context, not only does the Commission's price cap system not obviate the need for an effective and rigorous tariff review process that includes, among other things, a detailed examination of the costs that are allocated or otherwise attributed to the new service, the lack of a subsequent opportunity to revisit the pricing of any specific service once it has entered the ongoing price cap regime makes the initial review even more important than it had been in the pre-price cap era.

Assuming that the initial video dialtone rates are properly set and that costs motivated by the LEC's decision to enter the video/broadband business are correctly attributed to video and broadband services, application of the subsequent price cap treatment for new services, under the disaggregated, basket-specific PCI that the Commission has proposed and that the Committee strongly supports, should be capable of producing a result that is generally consistent with the Commission's "competitive outcome" objectives.

**VII. IF A SEPARATE X FACTOR IS UTILIZED AND PROPERLY IMPLEMENTED, NO SUBDIVISION OF THE NEW BASKET IS REQUIRED.**

If the Commission determines, as it should, that a separate price cap basket for video dialtone and other broadband distribution services should be established and that the X factor applicable to this basket should be disaggregated from the composite X factor that is applied to all LEC price cap services generally, that further disaggregation of this new basket would not be indicated at this time. As noted previously, the Commission has concluded that "[g]rouping services with common characteristics, such as similar levels of competition, within the same basket is intended to give the LECs pricing flexibility with respect to comparable services and to restrict the ability of LECs to offset increases for some services with rate decreases for dissimilar services."<sup>16</sup> At the present time, it would appear that video dialtone and other new broadband distribution services will in fact possess "common characteristics" with respect to their production, level of competition, and price elasticity of demand. Accordingly, the LECs should be permitted to design a rate structure and cost recovery paradigm within the video/broadband basket that will produce optimum market development and revenue generation, so long as these actions do not adversely affect customers of monopoly voice/narrowband services. If, however, the Commission concludes, now or in the future, that this

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<sup>16</sup> FNPRM at ¶ 7.

condition is not satisfied, separate baskets for video dialtone and other broadband services may then be indicated.

**VIII. COSTS AND REVENUES ASSOCIATED WITH VIDEO DIALTONE SHOULD NOT BE INCLUDED IN THE CALCULATION OF A LEC'S INTERSTATE RATE OF RETURN.**

In its recently-announced interim order in this proceeding regarding the X factor and sharing, the Commission has offered price cap LECs the option to operate either with or without a sharing requirement based upon each company's selection of its X factor.<sup>17</sup> Specifically, LECs electing the highest X factor of the three that were adopted -- 5.3% -- would no longer be subject either to a sharing requirement or to an absolute cap on earnings, nor would they be protected by a "low end" adjustment opportunity. However, LECs electing either the 4.7% or the 4.0% X factor options would continue to be subject both to sharing and to an absolute earnings cap.<sup>18</sup>

LECs that are subject to sharing and to low-end adjustments should not be permitted to combine their video dialtone/broadband earnings results with those for conventional voice/narrowband services in calculating the composite

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<sup>17</sup> See, Price Cap Order at ¶¶ 165, 214, 219-21.

<sup>18</sup> LECs electing the 4.0% X factor would be required to share all earnings in excess of 12.25% ROR on a 50/50 basis with ratepayers, and to return 100% of all earnings over 13.25% to ratepayers, thereby creating an effective earnings cap of 12.75%. LECs electing the 4.7% X factor would be required to submit to 50/50 sharing of all earnings between 13.25% and 16.25%, with 100% sharing in excess of 16.25%, resulting in an effective earnings cap of 14.75%.

rate of return. Since it is likely that, in the early years at least, LECs will either lose money or at least not realize substantial positive returns on their video investments, consolidation of the video and narrowband earnings into a single company-wide composite will have the effect of depressing overall LEC earnings, thereby avoiding some or perhaps all of any sharing or earnings cap obligations and effectively diverting these funds, which would otherwise be returned to ratepayers, directly into the LECs' video/broadband ventures. Worse still, potentially large losses in the video/broadband area could sufficiently depress composite earnings that the LEC might seek to increase rates for basic monopoly voice/narrowband services by invoking the low-end adjustment mechanism, thereby forcing monopoly ratepayers to underwrite risky competitive initiatives.

The Committee believes that the "reward follows risk" principle should apply in this situation. If costs are properly separated as between video/broadband and conventional voice/narrowband services (by, among other things, eliminating the large "common cost" categories and charging the bulk of these new acquisitions to the new competitive services, and through disaggregation of the X factor for the video/broadband and other price cap baskets), customers of the LECs' monopoly services should not be entitled to any subsequent share of excess earnings produced from the new investments.

## IX. CONCLUSION

The principal concern and danger raised by the FNPRM is that adoption of the proposal and the establishment of separate X factors may give the Commission a false sense of security, perhaps being used to support an erroneous conclusion that it has somehow "solved the problem" with respect to cost allocation and the potential for cross-subsidization and anticompetitive behavior by LECs. Price caps is simply not a panacea for resolving the problem of cross-subsidization, as LECs suggest. In actuality, of course, the *driver* for any ongoing price adjustments must necessarily be the start-up level of rates for the new VDT services, and those must be set in the tariff review process based upon a correct assignment of the so-called "common" network costs principally to the VDT category. The proposed separate basket solution, while clearly a necessary condition to achieve the Commission's goals of promoting investment and efficient use of the public network while precluding cross-subsidization and anticompetitive behavior, is not by itself sufficient to achieve these goals. Price caps regulation in and of itself, no matter how adapted, simply cannot address subsidization resulting from the incorrect assignment of costs at the outset to video/broadband categories. For this reason, a diligent and thorough tariff review and correct assignment of the underlying broadband network costs to the



video service category is and must remain a critical component of the  
Commission's video dialtone policy.

Respectfully submitted,

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By:

A handwritten signature in black ink, appearing to read "James S. Blaszak", is written over a horizontal line.

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